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Explain and discuss this statement: "The Bank's primary obligation to obey his customer's mandate strictly is supplemented by more general duties of care. Of increasing importance to banks are developments in the law of negligence which impose general duties of care based upon the general concept of proximity." Consider in your answer the impact upon Scots Law of the Mumford and Smith - v- Bank of Scotland decision.

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Introduction

In recent years, we have witnessed an expansion in the law of negligence in the banker-customer relationship. The rapid development in the law has not been simple and is by no means over but it is necessary to examine the position in the past, present and foreseeable future in order to grasp the full complexity of the law as it stands today. It is also necessary to examine the general concept of proximity to establish whether it remains the best way forward in the development of this area of law.

The nature of the banker and customer relationship

The nature of the banker-customer relationship defines the obligations which arise from it. The traditional view has been that the bank is not the custodian of the customer's money¹ nor is the relationship fiduciary but of debtor and creditor.² In the case of *Joachimson v Swiss Bank Corporation*³, it was examined in detail and held that the relationship was primarily contractual in nature.⁴ As Paget notes,

*"It consists of a general contract, which is basic to all transactions, together with special contracts which arise only as they are brought into being in relation to specific transactions or banking services."*⁵

If the relationship is of a contractual nature, then understandably, the terms of the contract signed will govern the relationship between the two and the banker will be obliged to follow the customer's mandate.⁶

When does the banker-customer relationship begin?

A duty of care is owed to the customer when the banker-customer relationship begins. A banker does not owe a duty of care to every person who passes through his doors yet at the same time, special circumstances can lead to the relationship arising where there is no bank account. In *Great Western Railway v London and County Banking Co.*⁷, Lord Lindley opined that,

*"I cannot think that Huggins was in any sense a customer of the bank; no doubt he was known at the bank as a person accustomed to come and get cheques cashed, but he had no account of any sort with the bank."*⁸

However, in *Woods v Martins Bank Ltd.*⁹ despite the fact that the plaintiff did not have an account with the defendant bank on the date in question, Justice Salmon held that he was in essence a customer of the

¹Royal Bank of Scotland v Skinner (1931) SLT 382

²Foley v Hill (1848) 2HL Cases 28

³(1921) All ER 92

⁴(1921) All ER at p 100 per Lord Justice Atkin

⁵Paget at p 110

⁶However, this is subject to certain exceptions, some of which will be illustrated below.

⁷(1901) AC 414

⁸as above, at p 425

⁹(1958) 1 QBD 55

bank. The court decided that there had been a special relationship created when the manager had agreed to provide financial advice to Woods:

"No doubt the defendant could have refused to advise the Plaintiff, but, as he chose to advise him, the law in these circumstances imposes an obligation on him to advise with reasonable care and skill."

The fact that he did not as yet have an account with the bank was immaterial. What was material was that the manager had acted in his capacity as manager of a bank when advising Woods, and that the bank advertised itself as an institution which would engage in such activities. The facts in each case must be examined carefully to establish whether the necessary degree of proximity exists between the parties to create the banker-customer relationship. The following situations where a duty of care arise will be examined in relation to proximity.

The obligations owed by a bank to its customer

The ordinary relationship of banker and customer has the effect of imposing certain added obligations upon bankers in the performance of their duties. Specific duties arise only where special arrangements have been made or special circumstances¹⁰ exist and in the absence of this, more general duties of care are owed. For instance, there exists a duty of confidentiality and also a duty to take reasonable skill and care in dealing with its customers financial matters. The duty of confidentiality arose in *Tournier v National Provincial and Union Bank of England*¹¹ in which states that the duty was binding on the bank unless it could demonstrate that it came within one of the following four exceptions: 1) Where the bank is under a compulsion by law to disclose. 2) Where the bank owes a duty to the public to disclose.¹² 3) Where the interests of the Bank require disclosure. 4) Where the bank has obtained the consent of its customer.

The duty of care owed by a bank to its customer

The specific duties of care that can be owed are far too numerous to mention but instead the growing expansion in the law of negligence in the banker-customer relationship should be examined in more depth. The most important of these arise when giving advice on financial matters, providing a reference of a customer and when giving advice on securities.¹³

The expansion in the law of negligence here has been partly due to the change in the nature of the banker-customer relationship. The Jack Report¹⁴ remarks that in the past,

"[T]he banker-customer relationship of those times was "based on a combination of service and friendliness amounting almost to paternalism". It was all very much in the context of the times; there

¹⁰see *Kpohraror v Woolwich Equitable Building Society* (1996) 4 All ER 119

¹¹(1924) 1KB 461

¹²*Libyan Arab Foreign Bank v Bankers Trust Co* (1989) QB 728

¹³There exists also a duty on a banker of safe custody when he accepts articles for deposit but this is unrelated to proximity and explained further in *Langtry v Union Bank of London* (1896) 1 LDAB 229.

¹⁴*Banking Services: Law and Practice Report by the Review Committee Feb 1989, Cm 622 HMSO Chairman - Professor R B Jack CBE (The Jack Report)*

was a climate of mutual trust and confidence, mistakes by banks were a most unusual occurrence, and frauds on banks very rare."¹⁵

Nowadays, instead of the more paternal image, the bank has taken on a more business like one, its staff acting as salesmen for a wide range of financial products and services.

Advice on financial matters

As part of the change in perception of the banking industry, an increasingly important part of the banker's job is to provide advice on financial matters. As already discussed, the duty of care owed varies with the degree of proximity between the parties, for instance the bank will not owe a duty of care to a third party who reads advice intended for another.¹⁶ The leading decision in this area is the *Woods Case*¹⁷ in which Justice Salmon opined that,

*"I find that it was and is within the scope of the defendant bank's business to advise on all financial matters and that, as they did advise him, they owed a duty to the plaintiff to advise him with reasonable care and skill."*¹⁸

In that case, special circumstances contributed to the decision which nowadays would not be required. The bank in that case had gone out of its way to advertise the fact that it was in the business of offering financial advice but in today's banking industry this has become so common place that it is likely to be within the realm of judicial knowledge.¹⁹ The duty of care owed extends to the,

*"ordinary care and skill which the ordinary bank manager in his position might reasonably be expected to possess."*²⁰

This skill of an ordinary bank manager in financial matters is presumed to be greater than that of the reasonable person, for the professional nature of their job inevitably demands this.²¹ If the bank is paid for the advice, the duty is somewhat more onerous.

Providing a reference on a customer

A bank may also be liable when giving a reference about the financial status of a customer, firstly to the customer who is the subject of the information and secondly to the recipient of the information. In providing a reference about a customer, there exist several possibilities. Where the statement is inaccurate or false in any way, an action is available to the customer in negligence based on the bank's failure to exercise reasonable skill and care in compiling the information.²² Where it is not inaccurate, a

¹⁵The Jack Report Chapter 2 Para 18 quoting a statement by one of the consultees to the report.

¹⁶*McInerny v Lloyds Bank Ltd* (1973) 2 Lloyd's Rep 389

¹⁷(1958) 1 QBD 55

¹⁸as above at p 71

¹⁹In fact, it may be harder for a bank to establish that it does not give financial advice.

²⁰*Woods v Martins Bank Ltd* (1958) 1 QBD at p 73 per Justice Salmon

²¹*Box v Midland Bank Ltd* (1981) 1 Lloyd's Rep 434 where the customer was entitled to rely on an 'opinion' the bank manager had stated

²²This is an extension of the duty found in *Spring v Guardian Assurance plc* (1995) 2 AC 296 which related to an employer-employee relationship based upon the employee's reliance on the employer to take reasonable care. The same is true of the banker-customer relationship.

breach of the confidentiality between banker and customer may arise unless the bank can show that the customer did consent to the provision of the information to a third party.²³ Confusion is arising on this issue for the *Tournier* case suggests that this consent may be either express or implied and a customer will be deemed to have consented unless they have expressly withdrawn their permission. However, more recently, section 4.5 of the Banking Code²⁴ states that,

*"If a banker's reference about you is requested, we will require your written consent."*²⁵

Furthermore, an action in defamation may exist where the customer's business or other reputation suffers as a result of a reference. However the onus is on the customer to show that the bank acted with malice in providing the reference. The proximity between the parties is not required in the defamation cases but in elsewhere, it will be relatively simple to establish for the bank is unlikely to give a reference about a person whose affairs it does not handle.

When considering, the recipient, *Hedley Byrne & Co. Ltd v Heller & Partners Ltd*²⁶ extended the duty of care to cases where a contractual or fiduciary relationship did not exist between the parties. Here, unlike in *Woods*, the appellants were not the customers or potential customers of the bank. The judgment revolved around the circumstances surrounding the actual giving of the reference and it was emphasised that:

*"[T]he law must treat negligent words differently from negligent acts."*²⁷

This is significant when we consider the potential effect of the negligence, for a negligent act can only really cause one accident, thus creating the necessary degree of proximity between the parties. However, negligent words can be recorded, copied, repeated and broadcast many times after they are originally made. To include in the degree of proximity every ultimate consumer who acts to his detriment would take this idea too far.

Hedley Byrne sought to make negligently uttered or written words to be binding in certain circumstances. There are a few criteria to which must be met first and these are:

"[I]f someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill, a duty of care will arise. The fact that the service is to be given by means of or by the instrumentality of words can make no difference.

*Furthermore, if in a sphere in which a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person takes it upon himself to give information or advice to or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise."*²⁸

²³see *Tournier Case* (1924) 1 KB 461

²⁴3rd Edition, March 1997 and also in 4th edition

²⁵However, it is as yet unclear as to the binding nature of this code in a court.

²⁶(1964) AC 465 hereinafter referred to as 'Hedley Byrne'

²⁷as above at p 482 per Lord Reid

²⁸as above at p 502 per Lord Morris of Borth-y-Gest

There are three conditions which can be ascertained from this. 1) The advisor must be possessed with some special skill, for example a solicitor, bank manager or other professional occupation. 2) They must voluntarily undertake to provide the information or advice and must also have consented to its distribution. 3) The advisor must know or ought to know that the advisee will rely upon the information and consequently, they are not liable if someone unknown to them relies upon the information.²⁹

The pursuer in *Hedley Byrne* did not succeed for the defendants had placed a disclaimer of liability in the document which the court had upheld. However this may be open to challenge nowadays by the Unfair Contract Terms Act 1977³⁰ but this is unlikely owing to the uncertain nature of financial advice, a disclaimer of liability appears fair and reasonable.

Advice on Securities

A duty of care can arise where the bank asks a customer to execute some form of security to guarantee the debts of another customer. The most common scenario is where a wife is asked to sign a standard security in favour of the bank to guarantee her husband's business debts. The cases arise where the husband has misrepresented his financial position to the wife or exercises some undue influence in obtaining her signature.

In *Lloyds Bank v Bundy*,³¹ the situation arose but between a father and son. The father was aged and naive in business matters, placing heavy reliance upon the advice of the bank manager. Lord Denning opined that,

*"There was such a relationship of trust and confidence between them that the bank ought not to have swept up his sole remaining asset into its hands - for nothing - without his having independent legal advice."*³²

Mr Bundy had been a customer of long standing relying strongly on the bank's advice and the bank knew of this reliance and therefore, owed him a duty to warn him of the consequences and to advise him to take independent advice. Where the bank has a conflict of interests it appears there is a stronger onus on the bank to advise independently.

In the case of *National Westminster Bank Plc v Morgan*,³³ the bank obtained no advantage from the transaction which was necessary to save their home, however the bank manager had not correctly informed Mrs Morgan as to the full extent of the document. In summing, Lord Scarman held that the bank manager,

²⁹ see *McInerny v Lloyds Bank Ltd* (1973) 2 Lloyd's Rep 389 although complications may arise if they choose to publish the information.

³⁰ as amended by section 68 of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 which added non-contractual notices into the scope of the Act.

³¹ (1975) 1 QB 327 hereinafter referred to as 'Bundy'

³² as above at p 340

³³ (1985) 1 AC 686

*"never "crossed the line". Nor was the transaction unfair to Mrs Morgan. The bank was, therefore under no duty to ensure that she had independent advice."*³⁴

The presumption of undue influence could not therefore apply where no advantage had been obtained by the bank and could be rebutted if no influence was unduly exercised.³⁵

The position in England

The law in England was extended dramatically by the House of Lords decision in *Barclays Bank v O'Brien*³⁶ in which the English concept of constructive notice was applied. Furthermore, the notion was created that where a wife offers to stand as cautioner for her husband's debts in a transaction which is not to her financial advantage, the creditor will be put on inquiry and must discover the circumstances in which the cautioner agreed to give the security.³⁷ This is not the law of Scotland.³⁸

The position in Scotland

In *Young v Clydesdale Bank Plc*³⁹ it was held that error induced by the representations of third parties was no ground for reduction in a question with the bank even where the cautioner had not read the document prior to signing. In *Royal Bank of Scotland v Greenshields*,⁴⁰

*"A bank-agent is entitled to assume that an intending guarantor has made himself fully acquainted with the financial position of the customer whose debt he is about to guarantee. And the bank-agent is not bound to make any disclosure whatever regarding the customer's indebtedness to the bank."*⁴¹

A creditor may, though, be bound to inquire further where the circumstances are such that would lead a reasonable man to believe that fraud had been used.⁴² However fraud is very much different to undue influence or misrepresentation in this context.

So stood the law in Scotland for many years, until the case of *Mumford and Smith v Bank of Scotland*⁴³ reached the House of Lords. The facts were very similar to the *O'Brien* case and the wives actions for partial reduction of the standard securities to the extent of their debt failed in all the lower courts but was allowed in the House of Lords. There are a few important facts in the case which must be noted. The wives had no financial interest in the transaction, had not been warned of the implications or

³⁴as above at p 709

³⁵as in *Cornish v Midland Bank plc* (1985) 3 All ER 513

³⁶(1994) 1 AC 180

³⁷see also the cases of *Massey v Midland Bank Plc* (1995) 1 All ER 929; *Banco Exterior International v Mann* (1995) 1 All ER 936; *TSB Bank plc v Camfield and Another* (1995) 1 All ER 951 for a guide to the further development of English Law along quite strict lines.

³⁸CEF Rickett in his article entitled "" that the Scottish position is far more preferable to the English one

³⁹(1889) 17 R 231

⁴⁰(1914) SC 259

⁴¹as above at pp 266-267 per Lord President Strathclyde.

⁴²*Owen and Gutch v Homan* (1853) 4 HL Cases p 1035

⁴³(1996) SLT 392 on appeal in the Court of Session and in the House of Lords - *Smith v Bank of Scotland* (1997) SLT 1061 and (1997) SC(HL) 111 hereinafter referred to as 'Smith'

advised to take independent advice. They both argued that they had been induced to sign as a result of misleading statements made by their husbands.

The House of Lords reached the same result as in *O'Brien* but for different reasons. As we see from Lord Jauncey, this was an entirely deliberate case of judicial legislation,⁴⁴

*"Applying the principles of Scots Law alone, I would therefore have been disposed to dismiss this appeal. Nevertheless I am conscious that your lordships do not share my difficulties and I appreciate the practical advantages of applying the same law to identical transactions in both jurisdictions."*⁴⁵

Had Mrs Smith's case been decided on the principles of Scots Law at that time, she would have been unsuccessful. Lord Clyde in *Smith* considered the obligations on a creditor in a contract of caution to disclose the financial position of the debtor. He found four circumstances in which such an obligation could exist, not one of which applies in this case. Instead, he found an underlying principle in each of the cases of,

*"the basic element of good faith."*⁴⁶

This, as he continues much later leads to a duty to give the cautioner certain advice,

*"where the creditor should reasonably suspect that there may be factors bearing on the participation of the cautioner which might undermine the validity of the contract through his or her intimate relationship with the debtor the duty would arise and would have to be fulfilled if the creditor is not to be prevented from later enforcing the contract."*⁴⁷

This is possible by creating a legal fiction deeming the bank to be a party or a participant in any misrepresentation by the debtor. This arises where the reasonable man on an examination of the facts would come to the conclusion that owing to the personal relationship between debtor and cautioner, the cautioner's consent may not be fully informed or freely given. Where this occurs, the creditor must warn the potential cautioner of the effects of the proposed transaction and advise them to take independent legal advice.

The decision may not have been decided in line with Scots Law at that time⁴⁸ but it becomes necessary now to examine the actual and possible effects of the new law.

Interpreting *Smith*

The concept of proximity appears to have been altered slightly for the purposes of the case. *Smith* does not focus on the proximity between banker and cautioner but between the cautioner and debtor. Indeed the 'fiction' creates a proximity or special relationship with the banker regardless of whether one actually existed.

⁴⁴A more scathing approach is taken in "The House of Lords "Applies" *O'Brien* North of the Border" by Laura MacGregor in Edin LR 1998 2(1) 90

⁴⁵(1997) SC at p 115

⁴⁶(1997) SC at p 118 B-C

⁴⁷(1997) SC at p 121 F-G

⁴⁸although the Jack Report had recommended such a result at Section 13.22 of its 1989 Report

The proximity between debtor and cautioner was commented on by Professor Joe Thomson⁴⁹ who believes that *Smith* extends the protection to heterosexual and homosexual cohabitantes as well as to husband and wife. The degree of proximity in the relationship may come into question where an engaged couple are not yet cohabiting or where a married couple are no longer living together. George Gretton⁵⁰ refers to the situation as "emotionally transmitted debt" but the crux of his article is the consideration of problems in establishing a clear ratio from the case. He outlines four possible ratios only one of which appears to be correct. Certainly the latter three provide too wide an interpretation of the case but the first, more likely to be correct is:

*"(1) If the relationship between the principal obligant and the proposed cautioner is close, and (2) if the creditor either (a) knows of that fact or (b) should reasonably be able to infer that fact from the circumstances, then (3) the creditor comes under a duty to negotiate in good faith. (4) The creditor's duty in such a case will normally be discharged by ensuring that the proposed cautioner is both (a) warned of the risks and (b) advised to take independent advice. (5) If the creditor fails to negotiate in good faith, then (6) if there is a vitiating factor in the cautioner's consent, and (7) if that factor is connected with the closeness of the relationship, then (8) that vitiating factor will be pleadable against the creditor."*⁵¹

The other three possibilities can be dismissed as follows. In the second ratio, he claims "*there is a duty in all contractual matters to act in good faith*"⁵² which contradicts widespread opinion that *Smith* only applies to cautionary obligations.⁵³ Whereas in the third and fourth ratios, he ignores the paramount necessity to establish that there was in fact a misrepresentation or undue influence exercised. The third ratio requires the cautioner to show they would not have entered the caution had the creditor advised them, which is impossible to establish in a court without considering all the hypothetical outcomes. The fourth almost certainly places an unacceptably heavy duty on the bank and should not be considered if the effect of *Smith* is to be limited.

In the recent Outer House decision of *Braithwaite v Bank of Scotland*⁵⁴ by Lord Hamilton, it is indicated that it is not the breach of the duty of care by the bank which provides the actionable wrong. Instead, it must be established that an actionable wrong exists against the creditor before there can arise an action against the financial institution.⁵⁵ It appears therefore that the courts too would prefer the first ratio outlined above limiting the effect of *Smith*.⁵⁶

⁴⁹Joe M Thomson - Regius Professor of Law - "Misplaced Concern?" SLG 1997 65(3), 124

⁵⁰in the article entitled "Sexually Transmitted Debt" at (1997) SLT 195

⁵¹(1997) SLT at p 196, Column 2

⁵²as above

⁵³Joe M Thomson - Regius Professor of Law - "Misplaced Concern?" SLG 1997 65(3), 124

⁵⁴(1999) SLT 33

⁵⁵This notion of the two stage test is considered in greater detail in the article by Scott F Dickson, entitled "Good Faith in Contract, Spousal Guarantees and *Smith v Bank of Scotland*" (1998) SLT 39

⁵⁶see also "Good Faith in Contracting" by Joe Thomson of the University of Glasgow

In *Royal Bank of Scotland v Etridge*⁵⁷ an examination of the term 'independent legal advice' ensued. It was decided that although a solicitor acting for the bank should not advise the cautioner lest a conflict of interests arise, the solicitor acting for the husband may also act for the wife where it can be shown that their financial interests in the proposed transaction are similar.

Good faith and *Smith*

There was, prior to *Smith*, no general principle of good faith in contracting and it is unlikely that this has changed. Instead, *Smith* appears to have extended solely to cautionary obligations and possibly only to cases based on similar facts.⁵⁸ The concept of good faith does go against the preceding case law which relied primarily on establishing a special proximity between the bank and cautioner. The use of good faith in this way does place the bank in an awkward situation and furthermore complicates the duty of confidentiality. Perhaps a fifth exception might be added although it could be said that it is in the interests of the bank to disclose the information to ensure it will benefit from the cautionary obligation.⁵⁹ It remains, though, to be seen how this principle will be applied in the future.

Problems with *Smith*

Problems may arise when we consider that the bank's true obligation ought to be to the customer but in circumstances where the bank owes a duty of care to a third party, which will prevail? Where both are customers of the bank, the bank may be acting against the interests of one customer in not disclosing the information and against the interests of the other in advising the former to seek independent legal advice. Where a client consults a solicitor on such issues, ironically, the best legal advice a solicitor could give would be negligent advice, thus safeguarding the position of the client in the event of the security being called up. This is not advisable, as the bank may have a remedy against the solicitors responsible due to the special relationship created between them. Any solicitor would know that in referring a customer to them, the bank is relying heavily upon their competence.

Furthermore, the effect of the decision in future transactions may well be slight for section 3.14 of the latest edition of the Banking Code already covers the requirements laid down in *Smith* and banks in general do follow this procedure. When we consider though, that,

*"Whereas Parliamentary legislation is prospective only,, judicial legislation is both prospective and retrospective, for, by a fiction, it is deemed always to have been the law."*⁶⁰

The effects could be disastrous, potentially leaving many such cautionary obligations open to challenge.

Proximity

⁵⁷(1998) TLR August 17th, dealing with six cases in total.

⁵⁸see "Good Faith and Utmost Good Faith - Insurance and Cautionary Obligation" by ADM Forte

⁵⁹see the third exception in the Tournier case above

⁶⁰article by George L Gretton - "Sexually Transmitted Debt" at page

In *Weir v National Westminster Bank plc*⁶¹ the concept of proximity was used to create a duty of care in a rather unusual circumstance. The plaintiff in the case was not the actual customer of the bank but an agent for a disclosed principal. The duty does not extend to all cases of agency, simply where, by way of a power of attorney, the agent is the sole signatory on the account. It was held that the same duty of care in detecting forgeries would apply to the sole signatory on the account regardless of whether or not they were the actual customer. The proximity having been created by the fact that his was the only signature which operated the account affected by forgery. The concept of proximity is very hard to define and possibly should remain that way for it is a label attached to a practical test used by the courts on examination of the facts of a case to apply a duty of care. This tool is useful in many ways allowing for the application of many different rules as well due to its flexible nature.

Conclusion

Many of the principles relied upon in today's banking law have been well developed since their introduction but the 'invention' of the concept of good faith introduced in *Smith* is in the early stages of its own development. Good faith appears only relevant to cautionary obligations in the banking situation but nonetheless could have much wider implications if its application is not limited. Proximity remains a very strong tool for establishing a banker-customer relationship through which a duty of care may arise and attempts to define it more accurately should be resisted. The future effect of *Smith* is likely to be slight due to the introduction of section 3.14 into the Banking Code but the validity of many similar existing cautionary obligations remain in doubt. The banker-customer relationship, remains in law a close one in which both parties owe each other an ever increasing duties of care.

⁶¹(1993) SC 515

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